APPENDIX

James L. Kichline
February 1, 1982

FOMC CHART SHOW -- INTRODUCTION

During our presentation this afternoon we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal policy assumptions used in the construction of the staff's economic and financial forecast. For monetary policy, the 4 percent growth of M1 assumed during 1982 represents the midpoint of the tentative range adopted by the Committee in July, and for 1983 we assumed 1/2 percentage point slower growth. The fiscal outlay and receipt assumptions include carrying through on the currently scheduled tax and expenditure cuts. In addition, we have assumed further expenditure cuts of about $15 billion in fiscal 1983 and increases in taxes of about $5 billion.

More information on the federal budget is presented in the next chart. Growth of expenditures slows over the forecast period as a result of reduced nondefense spending and the declining rate of inflation projected. But receipts are damped even more, reflecting the sluggish economy and tax cuts. Thus the budget deficit is projected to move above $100 billion in the current fiscal year and go higher in fiscal 1983.

Information available to us on the administration's budget figures is still tentative. However, it appears that the official budget will show a deficit a little below $100 billion this year and a declining deficit in fiscal 1983 and beyond. The falling deficit projection relies upon a more expansive economy than projected by the staff as well as imposition of larger expenditure cuts and tax raising measures.

On a high employment basis--the bottom panel--the budget swings into deeper deficit in 1982 and 1983, driven importantly by the personal tax cuts scheduled for the middle of each year. The very stimulative posture of the fiscal side runs against what we interpret as a rather restrictive monetary policy, as indicated in the next chart. Growth of M1, although somewhat higher this year than last, is still assumed at a rate well below other recent years. Given our view of the strength of spending and associated credit demands, it seems likely that holding down M1 growth will result in a maintenance of high interest rates as shown in the bottom panel.

Mr. Zeisel will continue the presentation with a discussion of recent and prospective nonfinancial developments in the domestic economy.

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Joseph S. Zeisel
February 1, 1982

FOMC CHART SHOW

Economic activity contracted sharply in the fourth quarter, as real GNP dropped at a 5¼ percent annual rate. As the upper right hand panel shows, industrial production had turned down in midsummer, declining by nearly 7 percent between July and December, close to the drop in the first half of 1980. The sectors that have been performing poorly over the past few years--housing and motor vehicles--were major contributors to the sharp fourth-quarter contraction. But weakness was widespread, and in fact, the only sector of industrial output continuing to grow late last year was defense production.

As the bottom two panels indicate, the labor market has been severely affected by the recent drop in activity. Employment declined sharply in the last three months of the year; in manufacturing the level dropped below the 1980 trough. As the right hand panel shows, the unemployment rate moved up to 8.9 percent in December, about equal to the highest rate since World War II. A further increa in joblessness seems likely in the near term given the continued high level of initial claims.

As reported in the Redbook, there appears to be considerable evidence of continued weakness in the economy in January. At the same time, there are suggestions in recent data that the current downswing in activity is losing momentum. Housing demands and activity may have turned the corner in the past few months, albeit at extremely low levels, and in the auto sector, it is difficult not to anticipate a pickup soon in assemblies from the January annual production rate of 3½ million, which is well under the recent sales pace.

The next chart presents our view of the outlook for real GNP growth through 1983. We anticipate the beginnings of recovery in the next several months, although such a turn would still be consistent with a substantially negative first quarter. The personal tax cuts in mid-1982 and 1983 are expected to provide the main impetus for expansion. Real GNP growth is projected to grow at a 3¼ percent annual rate in the last three quarters of 1982 and about 2¾ percent during 1983.

As the bottom panel indicates, we currently expect the contraction in real GNP to total about 2¼ percent, around the average for postwar cycles, although substantially under the nearly 5 percent drop in 1973-75. The expected recovery is stunted in comparison with past performance, constrained by monetary policy and slow increase in government spending; virtually every major sector of the economy is expected to grow more slowly than has been usual at this time in the cycle.

As the next chart shows, the major contribution to recovery comes from personal consumption expenditures. Responding to the scheduled tax cuts, we anticipate that real consumer spending will increase at an annual rate of 3 percent during the last six quarters of the projection. Although this is a substantial improvement from the pace over the past two years, it is not a particularly ebullient performance by past cyclical standards.

As the bottom panel shows, we are projecting the saving rate to remain relatively low by historical standards, largely in response to the comparatively moderate growth in real income. While tax reductions and incentives should result in some improvement in the volume of savings, we are projecting the saving rate to average only 5-3/4 percent in 1983, still well below the longer-run average.

The next chart addresses the outlook for housing. We feel the dominant factor affecting residential construction activity and damping a vigorous recovery in this sector will be continued high mortgage interest rates. We project these rates to edge off to about 16½ percent in the latter part of 1983--only about a point below the current level.

It is not unlikely that housing activity is now at, or close to, its trough. Starts rose by 13 percent in December after having leveled off the previous month and new house sales picked up in November. The unusually bad weather and the recent rise in mortgage rates might depress starts briefly. But growing demand pressures associated with population trends should provide some support to the industry, and sales are expected to be helped by increased use of creative financing and adjustable rate instruments. Nevertheless, given continued high mortgage rates and the persistence of an unfavorable economic environment, we are projecting a very anemic rate of starts for the next two years--1.1 million this year, and 1¼ million in 1983.

The next two charts summarize the forces that are expected to determine the path for business fixed outlays over the next two years. Investment outlays have held up remarkably well in the face of high interest rates and declining capacity utilization. But real business fixed investment did drop sharply last quarter, and as the top panels indicate, orders figures paint a sluggish picture for the near term.

Over the longer haul, liberalized depreciation, and investment related to defense production and the conservation of energy, should stimulate increased capital spending. But a number of fundamental factors are likely to continue to damp outlays. As the lower two panels show, the cost of debt capital is expected to remain very high and corporate profits are projected to improve only moderately.

Possibly the most important determinant is illustrated on the next page--capacity utilization. With rates of capacity use below 75 percent and with product markets weak, we expect little demand for expansion of capital stock except in the aforementioned defense and energy related areas. As the bottom panel indicates, a further moderate decline in real capital outlays is projected through most of this year and only a modest 2 percent growth is expected over 1983.

The next chart addresses another problem area--inventories. In recent years, businesses generally appeared to be making considerable effort to avoid the kind of inventory backup that plagued them in 1974. However, it is virtually impossible to completely anticipate a sharp decline in demand, and thus some degree of unintended stock accumulation is inevitable. At year-end auto dealers--particularly domestics--faced a substantial inventory problem--as the upper left panel indicates. But, as mentioned earlier, producers have taken draconian measures to cut production. Sales also perked up somewhat after the turn of the year; if they hold up, this situation could ease fairly soon. But the overall inventory/sales ratio for manufacturing and trade rose sharply during the autumn as sales weakened, and adjustments may take a number of months to be completed. As the bottom panel shows, we are projecting a moderate pace of liquidation in the first half of 1982, to be followed by a conservative pattern of increase in real inventory investment through the projection period--in fact, one that would be associated with a slight decline in the inventory/sales ratio.

The next chart addresses the government component of spending. Real federal defense purchases are projected to continue to rise strongly, at a 5 percent rate, in 1982 and accelerate to an 8 percent increase in 1983. For nondefense spending the wide swings shown in 1981 and 1982 are mainly the result of the timing of CCC and strategic petroleum reserve outlays; exclusive of these, nondefense spending shows relatively little change. On balance, real federal government purchases are projected to decline slightly in 1982, but are expected to rise briskly in 1983--by some 5 percent.

States and localities are not expected to provide the support to economic activity that was typical in past cycles. Real purchases in this sector fell sharply last year and are projected to fall a further 1¼ percent in 1982 and 1/2 percent in 1983. As indicated in the bottom panel, overall government purchases are projected to decline by about 1¼ percent this year, and to rise by only about 1½ percent in 1983.

The sluggish overall recovery we anticipate for the next two years portends continued weak labor demands, as seen in the next chart. Following a further contraction in employment, the modest recovery in output in the second half of 1982 and through 1983 will be absorbed to a large degree by a pickup in productivity, with scant job gains. As a result, we anticipate virtually no rise in employment for 1982 as a whole, and only a small increase in 1983.

As indicated in the second panel, the scarcity of job openings should continue to depress labor force growth. Consistent with the experience in other recent periods of sluggish deman we anticipate no increase in labor force participation rates overall. Nevertheless, the expansion of labor supply is likely to about keep pace with job creation, and the unemployment rate is projected to remain above 9 percent during the next two years.

As shown on the next chart, the rise in compensation costs eased somewhat in 1981, despite a large increase in social security taxes which offset some of the slowing in wage rates. We expect a gradual further moderation of compensation costs over the projection period, especially given the anticipated environment of sustained high unemployment. The spread of wage concessions recently and the absence of another large social security tax increase this year should support this trend.

As the middle panel shows, we also expect some help from productivity, which typically improves when aggregage demand picks up and more effective use is made of available capacity. In conjunction with the expected moderation in wage pressures, improved productivity should result in a distinct deceleration in unit labor costs, which are projected to be rising at about a 5½ percent rate toward the end of next year.

The outlook for inflation is addressed in the next chart Recent data suggest a broad slowing of price increases. We expect this improvement in inflation to be sustained in 1982 despite some temporary upward pressure on food prices resulting from bad weather. With continued slack in markets, energy prices are not expected to be a problem over the next two years. Overall, we are projecting inflation to unwind gradually, largely reflecting reduced labor cost pressures and continued generally weak product markets. We now project the gross business product prices to be rising at about a 5 percent rate by the end of 1983.

Mr. Truman will continue with a discussion of the international outlook.

E.M. Truman
February 1, 1982

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL

The red line in the top panel of the first international chart shows that the foreign exchange value of the dollar in January was about 17 percent higher than a year previously, although it was down 5 percent from the peak rate shown for August. Over the forecast period, we expect the dollar's average value to decline gradually as the U.S. current-account deficit widens.

As can be seen from the lower panel, the size of the differential between dollar and non-dollar short-term interest rates does not offer much of an explanation for the dollar's strength during the past year. Indeed, the differential is now somewhat narrower than it was a year ago. However, in recent months changes in the dollar's value do appear to have been positively correlated with changes in the differential in short-term interest rates. The decline in foreign interest rates from August to November was less than the decline in dollar rates, and the dollar depreciated moderately. In December and January, as dollar interest rates rose, foreign rates continued to decline and the dollar appreciated. Over the forecast period, we expect interest rates abroad will generally edge down further.

One factor contributing to the dollar's appreciation over the past year has been the political situation in Poland and in Europe more generally. However, to understand fully the dollar's sustained strength, one must look beyond international politics and relative interest rate developments to the basic thrust of U.S. economic policy, compared with the policies abroad. The actual and expected impacts of those policies on inflation are especially important. One manifestation of such underlying determinants is depicted in the top panel of the next chart. In 1981, the rate of increase in U.S. consumer prices was less than the average experienced abroad -- for the first time in four years. More importantly, this pattern is expected to continue during the forecast period.

As is shown by the red line in the middle panel, on average economic activity abroad was essentially stagnant during 1980 and 1981. Although a moderate expansion is projected for this year and next, the pace of recovery will not reach the average growth rate prior to 1973 and will be slower than in the recovery following the 1974-75 recession.

The bottom panel illustrates the frustrating situation confronting many policymakers abroad. Although the averaging process may slightly exaggerate the picture, the unemployment rate in major foreign industrial countries showed little or no decline after the 1974-75 recession, increased sharply during the past two years, and is likely to remain essentially unchanged during the next two years. Meanwhile inflation on average is expected to decline only gradually.

Turning to the outlook for the external sector of the U.S. economy, the top panel of the next chart shows that non-agricultural exports have been declining in volume since the middle of 1980 and declining in value since the middle of last year. These declines have been spread widely across commodity groups. In recent months, exports of civilian aircraft, and of automobiles to Canada, have been particularly depressed. The dollar's appreciation and sluggish growth abroad have contributed to the decline in U.S. nonagricultural exports. Over the forecast period, these two factors are expected to diminish in strength and importance. However, as is shown in the chart, we do not expect a pickup in the volume of non-agricultural exports until early next year.

The outlook for agricultural exports, shown in the bottom panel, is somewhat more favorable. Although the price of these exports is expected to be lower on average this year than last, an increase in export volume associated with low stocks abroad should push up their value.

On the import side, shown in the next chart, the value and, especially, the volume of non-oil imports have been rising since mid-1980. Under the influence of the strong dollar, the average price of such imports actually declined at more than a five percent annual rate over the past three quarters.

Consequently, the volume of non-oil imports has risen across a broad spectrum of commodity categories, although imports of steel and automotive products from countries other than Canada have been quite moderate recently. We are projecting a small dip in non-oil imports this quarter and next, reflecting the U.S. recession, followed by a gradual rise through the remainder of the projection period.

Oil imports, shown in the lower panel, were unchanged in value in the year 1981 and declined significantly in volume. The price of U.S. oil imports declined more than $3 per barrel after reaching a peak of more than $36 per barrel in April. Although the price of imported oil rose slightly last quarter, we are assuming little further change this year and a constant real price in 1983. These assumptions, combined with a continuing gradual decline in import demand, are expected to produce a $10 billion drop in the value of oil imports this year on average, followed by a small rise in 1983.

The last international chart summarizes our projection for the external sector. As is shown in the top panel, the trade deficit is expected to level off in the first half of this year before reaching about $45 billion in 1983. Meanwhile, the surplus on non-trade current-account transactions is expected to shrink gradually as a consequence of lower earnings on direct investments abroad and a decline in the average level of dollar interest rates, which reduces net income on other investments.

Thus, as is shown in the middle panel, the U.S. current account should move gradually into deficit reaching a rate of about $20 billion next year.

In terms of the GNP accounts, shown in the bottom panel, the lagged effects of the dollar's appreciation on real exports of goods and services are expected to continue to exert a negative influence on U.S. economic activity throughout 1982. The same factor will raise imports, except that in the first half of the year the effects of the appreciation are largely offset by lower overall domestic demand. It would be misleading, however, to interpret these negative impacts as if the dollar's appreciation has occurred in a vacuum. As I noted earlier, the appreciation has been in large part the consequence of U.S. economic policies adopted in recent years, and the declines in GNP net exports are best viewed <u>also</u> as a consequence of those policies.

Mr. Prell will now continue our presentation.

Michael J. Prell
February 1, 1982

FOMC CHART SHOW--DOMESTIC FINANCIAL

As has been indicated, we see a restrictive monetary policy limiting the expansion of economic activity over the next two years. This restrictive influence on the economy is mirrored in the staff's projection of aggregate flows of funds shown in the top panel of the next chart. Total funds raised by domestic nonfinancial sectors has been virtually flat since 1978, and we see only moderate growth, on net, by 1983. Such growth would hold the ratio of funds raised to GNP--the red line--at its recent lower level.

Moreover, as may be seen in the lower panel, the U.S. Treasury will be absorbing a growing share of overall credit. A movement of fiscal policy in an expansive direction is common during recession and early recovery, but its continuation in the current environment of monetary restraint does seem to be a recipe for high real interest rates and a "crowding out" of private capital formation.

The next chart focuses on the nonfinancial corporate sector, where investment is expected to be lackluster over the next two years. The top panel indicates that, given weak profitability, there will continue to be a moderate gap between outlays and internal funds generated. Thus, we will not be seeing quite the typical cyclical respite in financing needs.

Owing to high interest rates and weak cash flows, many companies--especially those heavily reliant on short-term or floating rate debt--already have encountered difficulty in meeting debt servicing needs. As shown in the middle panel, net interest payments will continue to command a large share of income over the projection period. Moreover, absent a considerable improvement in the bond markets, we are likely to see a drift toward more vulnerable balance sheet structures. For example, the ratio of short-term to total debt, in the bottom panel, already is at a record high, and it would take a massive volume of bond issuance to achieve reversal of the downtrend. The figures underlying this graph anticipate somewhat more bond issuance than in 1981 and a drop off in the merger activity that has absorbed stock and increased borrowing.

On the whole, these data point to an area of risk in the GNP projection: to date, the financial dislocations in the corporate sector have been well confined, but the possibility of broader disruption can not be dismissed.

The same sort of concerns arise--perhaps with less intensity--with respect to the household sector, shown in the next chart. Household borrowing, in the top panel, has shrunk dramatically over the past few years. The enthusiasm for leveraging up and acquiring houses and other tangible "inflation hedges" has ebbed as real interest rates have risen and income prospects have become less certain. We are looking for a weak pattern of borrowing in 1982-83; indeed, as indicated by the red line, borrowing is projected to fall still further relative to disposable income.

Household financial caution is likely to be reinforced by lender behavior. Deteriorating earnings margins and concerns about credit quality have prompted many institutions to tighten their lending policies. These actions have, we believe, been evident not only in the credit flow data but also in the loan delinquency figures. As may be seen in the lower panels, delinquency rates on installment loans have declined over the past year, while those for mortgages have risen. The contrast reflects at least in part the quicker impact of corrective actions in the case of the short maturity loans. Looking ahead, it appears probable that many households will be struggling with debts that have accumulated over the years, with a particular area of vulnerability being the short-term mortgage obligations that have been assumed in anticipation of attractive refinancing opportunities.

The next chart is devoted to the state and local government sector. The top panel shows that, despite the restrained spending outlook, the operating surplus of states and localities is expected to disappear. The cutback in federal grants stands out quite clearly as a key factor here; as can be seen in the middle panel, those grants are programmed to fall considerably. Furthermore, this will occur at a time when many states have depleted their cash reserves.

Not surprisingly, there has been some talk of state and local financial difficulties; however, to date, such concerns have not been manifest in any clear way in the municipal securities market. As shown in the bottom panel, the yields on municipal bonds have risen markedly relative to those on taxable obligations, but this apparently reflects primarily a reduced desire for tax exempts on the part of banks and casualty insurers.

Mr. Kichline will now conclude the presentation.

James L. Kichline
February 1, 1982

FOMC CHART SHOW -- CONCLUSION

The staff forecast entails sluggish growth of output on average over the next two years. The top panel of the chart indicates that the very slow growth of real GNP since the end of 1978 has led to a downturn in actual GNP relative to potential and a further decline is projected given the forecast of activity. Slack in markets was influential in bringing down the rate of inflation last year and we anticipate further, considerable improvement over the forecast period, shown in the lower panel of the chart. The combination of reduced but still high rates of inflation, high unemployment, and high interest rates obviously poses difficult problems, ones not confined to the United States. And it is a situation that has appreciable financial risks.

The staff forecast for 1982 is not markedly different from the figures provided by Committee members, which are summarized on the last chart. The chart does not contain information on the administration's forecast which will underlie the official budget program to be released next week. The tentative information suggests they will probably have a projection of nominal GNP growth in the area of 10-10½ percent, with real GNP growth of around 3 percent and a deflator of 7 percent. The unemployment rate in the fourth quarter of 1982 could be about 8½ percent.